United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-4211

Signed

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

NORMAN and ARLENE RODMAN,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

MARTIN and PHYLLIS RODMAN,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

ESTATE OF ROBERT RODMAN, Deceased, GERTRUDE RODMAN, Administratrix, and GERTRUDE RODMAN,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

ESTATE OF SYDNEY NEWMAN. Deceased, DOROTHY NEWMAN, Executrix, and DOROTHY NEWMAN, Surviving Spouse,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

ESTATE OF SYDNEY NEWMAN, Deceased, DOROTHY CLIFFORD NEWMAN, Executrix, and DOROTHY CLIFFORD NEWMAN, Surviving Wife,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

ON APPEALS FROM DECISIONS OF THE UNITED STATES TAX COURT

BRIEF FOR THE COMMISSIONER

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
ERNEST J. BROWN,
DAVID ENGLISH CARMACK,
Attorneys,
Tax Division,
Department of Justice,
Washington, D. C. 20530.

2

TABLE OF CONTENTS

CITATIONS

Cases:

Page

Cases (continued):

Page

Cases (continued):

Statutes:

Page

Miscellaneous:

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 75-4211

NORMAN and ARLENE RODMAN,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

MARTIN and PHYLLIS RODMAN,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

ESTATE OF ROBERT RODMAN, Deceased, GERTRUDE RODMAN, Administratrix, and GERTRUDE RODMAN,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

ESTATE OF SYDNEY NEWMAN, Deceased, DOROTHY NEWMAN, Executrix, and DOROTHY NEWMAN, Surviving Spouse,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

ESTATE OF SYDNEY NEWMAN, Deceased, DOROTHY CLIFFORD NEWMAN, Executrix, and DOROTHY CLIFFORD NEWMAN, Surviving Wife,
Petitioners-Appellants-Cross-Appellees
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant

ON APPEALS FROM DECISIONS OF THE UNITED STATES TAX COURT

BRIEF FOR THE COMMISSIONER

STATEMENT OF THE ISSUES PRESENTED

Taxpayers'[1/] Appeals.

1. Whether the Tax Court correctly determined that an alleged $900,000 note made to the order of Aurele Brisson was not a bona fide cost of Torbrook stock bought and sold in 1956 by a joint venture of which the taxpayers were members.

1/ Norman Rodman, Martin Rodman, Robert Rodman, and Sydney Newman will be referred to from time to time herein as taxpayers.

2. Whether the taxpayers sustained net operating losses in 1958 because of alleged abandonments of their joint venture interests that could be carried back to their 1956 tax years and for Martin Rodman carried forward to his 1959, 1960, 1961, and 1962 tax years.

3. Whether the $250,000 paid to the joint venture on July 17, 1956, by General Tire & Rubber Company was correctly determined by the Tax Court to be taxable as ordinary income rather than as long-term capital gain.

4. Whether the Tax Court correctly concluded that taxpayer Martin Rodman was taxable on his pro rata share of the joint venture's income for the entire year when he was a member thereof for less than two months.

5. Whether, if the taxpayers had additional income from the joint venture in 1956, their wives were innocent spouses under Section 6013(e) of the Internal Revenue Code of 1954 and relieved of liability for taxes and interest thereon.

6. Whether the Tax Court correctly disallowed certain of the joint venture's alleged business expense deductions for 1956 and 1957.

1/ (continued)

Arlene Rodman, Phyllis Rodman, Dorothy Newman (in her individual capacity), and Gertrude Rodman (in her individual capacity) are taxpayers because they filed joint returns with their husbands. Robert Rodman died on September 29, 1968. Sydney died on June 30, 1963. (Op. 9.) Their estates have been substituted as parties in this litigation. The Estate of Sydney Newman and Dorothy Newman appear twice because of the different manner in which they entitled their petitions to the Tax Court. This stylistic difference has no significance.

The Commissioner's cross-appeal.

Whether, if the alleged $900,000 note to Aurele Brisson was a bona fide cost of Torbrook stock, the payee of that note forgave the payment thereof and thus generated income in that amount for the joint venture in 1957.

STATEMENT OF THE CASE

The Commissioner asserted deficiencies in federal income tax and penalties against (1) Norman and Arlene Rodman for the years 1956, 1957, and 1959 through 1962 in the total amount of $952,948.34; (2) Martin and Phyllis Rodman for the years 1956, 1957, and 1959 through 1962 in the amount of $864,041.08; (3) Robert and Gertrude Rodman for the years 1956, 1957, 1960, and 1962, in the amount of $797,667.41; and (4) the Estate of Sydney Newman and the decedent's wife, Dorothy, for the years 1956, 1957, and 1959 through 1962 in the amount of $1,383,483.62. (Op. 2-5.)[2/] Taxpayers' appeal involves the Tax Court's deficiency determinations for Norman and Arlene Rodman's tax years 1956 and 1957, for Martin and Phyllis Rodman's tax years 1956, 1957, and 1959 through 1962, for the Estate of Robert Rodman and the decedent's wife's tax years 1956 and 1957, and for the Estate of Sydney Newman and the decedent's wife's tax years 1956 and 1957. (Taxpayers' Br. 3.) The Commissioner's cross-appeal involves the Tax Court's decision concerning each taxpayer's 1957 tax year.

2/ References are to documents comprising the original record on appeal.

The memorandum findings of fact and opinion of the Tax Court (Judge Quealy) in these consolidated cases were filed on December 19, 1973, and are reported at 32 T.C.M. 1307. The Tax Court entered decisions in these cases on July 7, 1975. On September 18, 1975, taxpayers filed a notice of consolidated appeals. The Commissioner filed his notices of appeal on October 30, 1975. Jurisdiction is conferred on this Court by Section 7482, Internal Revenue Code of 1954.

The facts as stipulated by the parties or as found by the Tax Court may be summarized as follows:

The individual taxpayers, as well as Sydney Newman's estate, were residents of the State of New York at the time of filing the petitions with the Tax Court. (Op. 9.)

Robert Rodman (Robert) and his son, Norman, entered into a joint ventu[illegible]th Sydney Newman (Sydney) and Walter Ornstein (Walter) in 19[illegible] Each member had a 25 percent interest in that joint venture. On November 2, 1956, Walter sold his interest to Robert, Norman, and Sydney, leaving each with a 33 1/3 percent interest. On November 5, 1956, Martin Rodman (Martin), Robert's son, was admitted to the joint venture.[3] After Martin entered the joint venture, Sydney had a 33 1/3

3/ There is nothing in the record as to the way that Martin acquired his interest in the joint venture.

percent interest, Robert had a 22 2/3 percent interest, and Martin and Norman each had a 22 percent interest.[4/] Partnership returns for the joint venture were filed on the accrual basis of accounting. Such returns were prepared by Norman Elliott (herein referred to as Elliott), a Certified Public Accountant. (Op. 5-6, 9-10, 31-32.)

During the year 1955, the activities of the joint venture were directed principally to the acquisition of control of A. M. Byers Company, Inc., a listed corporation. In 1956, the joint venture was engaged primarily in trading the stock of Torbrook Iron Ore Mines, Ltd., a Canadian company (Torbrook). (Op. 10; Stip. par. 7.)

(1) The issue of the alleged $900,000 note[5/]

Torbrook was incorporated in early 1956 to promote prospecting licenses issued by the Minister of Mines of Nova Scotia. At the time of its incorporation, a total of 1,900,000 shares of Torbrook stock were to have been issued to Henri Leroux, Aurele Brisson, Sydney Newman and various nominees. Aurele Brisson, a Montreal attorney (herein Brisson), was to have paid $100,000 for 500,000 shares of Torbrook stock. There is no evidence

4/ The members of the joint venture did not use these percentages to compute their distributive shares of its losses and profits. Rather they used the following fractional basis to compute their distributive shares: Sydney, a one-third interest, and Robert, Martin and Norman, each a two-ninths interest. The decisions below were computed on this basis. (June 2, 1975, Tr. 17-18.)

5/ As the taxpayers have done, we will group the facts with respect to each issue. The facts set forth under the issue of the alleged $900,000 note cover the first issue presented on taxpayers' appeal and the issue presented on the Commissioner's cross-appeal.

whether Brisson exercised his right to subscribe to 500,000 shares of Torbrook or whether such right was transferred to the joint venture prior to its exercise. In any event, the joint venture acquired and had available for sale in 1956 a total of 1,179,050 shares of Torbrook stock at a cost of $1,846,182.73, exclusive of the amount in dispute herein, and realized during that year $2,574,903.34 from the sale of 835,055 shares of that stock to the public. Allegedly, Robert, as agent for the joint venture, acquired in May, 1956, the 500,000 shares to which Brisson was entitled under an agreement with him for 21 cents a share plus the transfer to Brisson of 20 percent of any additional shares of Torbrook stock which the joint venture might thereafter acquire. There was no evidence introduced at trial to show that this purported agreement with Brisson was a bona fide unconditional obligation of the joint venture. (Op. 10-12, 16-17, 39.)

When this purported agreement with Brisson came to the attention of Elliott, the accountant for the joint venture, in September, 1956, he suggested that a liability in a sum certain be substituted for the 20 percent interest. Upon request to draft a substitute, Elliott submitted a letter, which in essence provided that Brisson would accept a non-interest-bearing note for $900,000 from the joint venture payable on November 15, 1960, in exchange for terminating his right to receive 20 percent of any additional shares of Torbrook stock under the May, 1956, agreement and would agree to the cancellation of the unpaid balance of the note if he purchased or sold Torbrook stock or otherwise profited

from the company's operations without the permission of the joint venture. A letter dated November 3, 1956, embodying Elliott's suggestions was purportedly accepted by Brisson--though there was no evidence in the record to authenticate it or otherwise to show it to be a bona fide unconditional obligation of the joint venture. (Op. 12-14, 16-17, 39.)

In May, 1957, Elliott received the draft of the purported amended agreement, together with a photocopy of a purported note dated November 3, 1956, whereby Robert Rodman (on behalf of the joint venture) promised to pay to the order of Brisson, on or after November 15, 1960, the sum of $900,000. On the basis of these documents, Elliott thereupon accrued the sum of $900,000 as part of the cost of the Torbrook stock to the joint venture. (Op. 14-15.)

In the effects of Sydney Newman at his death were the original note for $900,000 and a letter dated January 7, 1957, purportedly from Brisson to Robert Rodman wherein Brisson acknowledged receipt from Robert Rodman of 200,000 shares of Torbrook stock in full and final payment of the $900,000 note. Taxpayers, however, concede that 200,000 shares of Torbrook stock were never delivered to Brisson. No evidence was introduced to show that the note had ever been delivered to Brisson or subsequently satisfied. Nor was there any evidence to show that either the original or the amended agreement with Brisson was bona fide or intended to be a bona fide obligation. (Op. 16-17.)

When Walter withdrew from the joint venture on November 2, 1956, he had never heard of Brisson or of any obligations which the joint venture might have had toward him. When Martin became a member of the joint venture on November 5, 1956, he was unaware of any significant liabilities which the joint venture might have had outstanding against it. (Op. 17.)

The Commissioner determined that the joint venture had no bona fide unconditional obligation in 1956 to pay Brisson $900,000 for the Torbrook stock and, accordingly, reduced the joint venture's cost of Torbrook by that amount. Alternatively, the Commissioner determined that if the $900,000 note was a bona fide cost of Torbrook stock in 1956, the joint venture received income in 1957 in the amount of $900,000, the distributive shares of which were reportable by the individual members of the joint venture, by reason of a forgiveness of indebtedness upon the cancellation of the note. The Tax Court determined that there was no evidence to show that the joint venture had an unconditional obligation to pay Brisson $900,000 or that the purported note was ever delivered to Brisson and was subsequently satisfied. Accordingly, it sustained the Commissioner's reduction of the joint venture's cost of Torbrook stock for 1956 by $900,000. (Op. 6, 16-17, 39.)

(2) Net operating loss carry-backs and carry-forwards

On March 19, 1957, the Securities and Exchange Commission obtained a judgment by consent to the entry of a permanent injunction by the United States District Court for the Southern

District of New York whereby Sydney and Robert were permanently enjoined from trading in Torbrook stock unless and until such stock was registered with the Commission. (Op. 30-31.) The Commissioner agreed that the joint venture's inventory of Torbrook stock became worthless in 1958 and that such loss was deductible by the joint venture as an ordinary loss in 1958. The distributive shares of this loss could be carried back by the members of the joint venture under Section 172 of the 1954 Code to their tax years 1955 and/or 1956. (June 2, 1975, Tr. 3-4; Stip. par. 5c; Supp. Stip. pars. 3, 24.)

Taxpayers contend that their ordinary losses in 1958 were greater than that allowed by the Commissioner by reason of the abandonment of their interests in the joint venture in that year and that this increase in their ordinary losses in 1958 entitled all taxpayers to carry back greater net operating loss deductions to 1956 and entitled Martin to carry over net operating loss deductions to 1959, 1960, 1961, and 1962.[6/] At the Rule 155 Hearing, the Tax Court rejected taxpayers' claim because there was no evidence as to the value of taxpayers' bases in the joint venture and because even if such bases had been proved, the loss was a capital loss. (June 2, 1975, Tr. 4-12.)

(3) The $250,000 payment

During 1955, the joint venture attempted to acquire control of A. M. Byers Company, Inc. (hereinafter Byers), a publicly traded corporation. It engaged in a proxy fight with General Tire &

6/ Amendment to amended pet., T. C. Dkt. Nos. 5779-65, 5782-65, 5783-65, 5786-65, 2345-67, 3737-67.

Rubber Company (hereinafter General Tire) and eventually lost, having incurred a total of $380,677.23 in proxy expenses. (Op. 21.)

On July 3, 1956, Sydney and Norman, as agents for the joint venture, entered into an agreement with General Tire which provided, in pertinent part, that in exchange for General Tire's payment of $250,000 the joint venture agreed (1) to accept, if made, an offer of General Tire to exchange the joint venture's Byers stock for General Tire stock; (2) to notify the banks and brokerage firms holding the joint venture's Byers stock to accept such offer within 10 days after it is made; (3) to assign to General Tire all the joint venture's interest in a United States patent application number 363,362; (4) to assign to General Tire the joint venture's claims against Byers arising out of expenditures relating to the solicitation of proxies in connection with meetings of Byers' shareholders; (5) to refrain for a period of five years from the date of the agreement from acquiring, directly or indirectly, shares or other securities of Byers and from taking any action that would hinder, delay, or interfere with the consummation of any offer by General Tire for Byers stock; and (6) to pay General Tire $25,000 if one variation of the offer to exchange General Tire stock for Byers stock were made. Having carried out part of the agreement, the joint venture received $250,000 on July 17, 1956. On December 12, 1957, the patent application was forfeited for failure to pay the final filing fees. (Op. 21-25, 26.)

On its 1956 informational return, the joint venture characterized the $250,000 as long-term capital gain from the sale of a patent. And the members of the joint venture so reported it on their 1956 returns. The Commissioner, however, determined that the $250,000 was given to the joint venture for not opposing General Tire's attempt to acquire control of Byers and thus treated it as ordinary income. In their brief in the Tax Court, the taxpayers also claimed that the amount was entitled to capital gain treatment because it was received as an exchange for the option given General Tire to purchase the joint venture's Byers stock. The Tax Court sustained the Commissioner's treatment of the $250,000 because taxpayers introduced no evidence that the patent application has any value or to show what portion of the value, if any, was attributable to the patent application or to the option to purchase the joint venture's shares of Byers stock. (Op. 26, 41-42.)

(4) Martin's portion of joint venture income for 1956

As set forth above, Martin acquired a 22 percent participation in the joint venture on November 5, 1956. At the time that he became a member of the joint venture, there was no discussion of his participation in the profits and losses therein. Further, the joint venture agreement provided no indication as to his participation in the profits and losses therein. (Op. 32.)

Prior to becoming a member in the joint venture, Martin had assisted the joint venture on several occasions and had worked for a company that was controlled by the joint venture. He,

however, received no compensation from the joint venture for his services. Rather, his father, Robert, gave him money as he needed it. He also drew on his savings and borrowed money from his father-in-law. (Op. 32-34.)

In its return for the taxable year 1956, the joint venture attributed two ninths of the reported loss of that year to Martin. Martin correspondingly included two ninths of that loss on his individual return. Further, Martin was allocated two ninths of the net long-term capital gains incurred during 1956, which he reported on his individual return. (Op. 34-35.)

Because the Commissioner disallowed the purported $900,000 note to Brisson as a cost for Torbrook stock, the joint venture had a profit rather than a loss. The Commissioner allocated two ninths of this profit to Martin on the ground (1) that Martin was in fact a member of the joint venture prior to November 5, 1956; (2) that Martin had been allocated all of the loss or profit of the joint venture after he became a member in November 5, 1956, up to the maximum of two ninths of the joint venture's profit or loss for the entire year; or (3) that the parties intended to amend the joint venture agreement to allow Martin retroactively two ninths of the full years profit and loss. (Op. 46-47; June 2, 1975, Tr. 21; Resp. Br. in Tax Court, pp. 71-79.)

During the Tax Court proceedings, Martin claimed that he was entitled only to two ninths of the profits earned of losses realized by the joint venture after he became a member. On the basis that Martin and the other members of the joint venture

reflected their understanding of the agreement by reporting their respective distributive shares of the joint venture's income and loss in accordance with the joint venture's return, the Tax Court held that Martin was taxable on two ninths of the profits and losses realized by the joint venture for the entire year, reduced by any of the items described in Section 702(a) of the Internal Revenue Code of 1954 attributable to the withdrawing party, Walter, under Section 706(c)(2)(A)(i) of the Code. (Op. 32, 44-48.)

(5) <u>The innocent spouse issue</u>

The taxpayers' wives contend (Taxpayers' Br. 19-20) that they are entitled to relief from any tax that might be owed for 1956 by their spouses by reason of Section 6013(e) of the Internal Revenue Code of 1954. That section provides certain conditions under which an innocent spouse will be relieved of any income tax liability attributable to an omission from gross income by the other spouse of an amount in excess of 25 percent of the amount of gross income stated in the joint return.

At the trial of the case on October 10, 16 and 17, 1972, the taxpayers' wives submitted no evidence on this issue, offered no reason why such evidence was not introduced, and made no request that the record be left open for introduction of evidence on this issue. (Op. 38.) On October 31, 1973 (more than one year after the trial), the taxpayers' wives moved to reopen the record to submit evidence on this issue and claimed in support of their motion that they were either unavailable, sick or aged. The Tax Court denied their motion on November 13, 1973. (Docket Entries.)

The Tax Court found that the taxpayers' wives were not entitled to relief under Section 6013(e) because there had been, as a matter of law, no 25 percent omission from gross income and because the taxpayers' wives had failed to establish that they met the other requirements of that section. (Op. 51-53.)

(6) The disallowance of alleged business expenses of the joint venture for 1956 and 1957

In its 1956 return, the joint venture claimed a sales expense deduction of $124,804.19 and a travel and investigation deduction of $9,445.56. The Commissioner disallowed the full amount of the sales expense deduction and $6,685.73 of the claimed travel and investigation deduction for lack of substantiation. Taxpayers presented no evidence to substantiate these deductions. Accordingly, the Tax Court sustained the Commissioner's action with respect to them. (Op. 27, 42.)

In its 1957 return, the joint venture claimed a sales expense deduction of $40,793.90, a travel and investigation deduction of $7,688.98, a deduction of $2,700 for commission expenses, and a deduction for legal and accounting expenses in the amount of $64,053.88. The Commissioner disallowed $40,276.38 of the sales expenses claimed, $61,117.88 of the claimed legal and accounting expenses, and all of the claimed expenses for commissions and travel and investigation for lack of substantiation. The taxpayers failed to introduce any evidence to support their claimed deductions. Accordingly, the Tax Court sustained the Commissioner's disallowance of them. (Op. 27-30, 43.)

SUMMARY OF ARGUMENT

The issues involved in these appeals arose out of adjustments made by the Commissioner in taxpayers' distributive shares of a joint venture, which for tax purposes is treated as a partnership. A partnership is not a taxable entity. Rather its members include in their incomes their distributive shares of its profits and losses. Except for one issue of law, the taxpayers have failed to show error in the Tax Court's factual determinations or legal conclusions. The Commissioner's cross-appeal is protective only.

The Taxpayers' Appeal

(1) The $900,000 note issue

In 1956, the joint venture was engaged in the business of trading Torbrook stock. The Commissioner determined that the joint venture had overstated its cost of the stock by $900,000 because there was no unconditional obligation to pay Brisson that amount. No evidence was produced by taxpayers showing that the joint venture had any definitive obligation to pay $900,000 to Brisson. Indeed, what evidence was introduced indicated that there was no agreement to pay Brisson any amount. The Tax Court's determination that there was no unconditional obligation to pay Brisson $900,000 comes to this Court under the clearly erroneous rule. Taxpayers have failed to show any error in the Tax Court's determination.

(2) The net operating loss carry-back and carry-forward issue

In 1958 the Torbrook stock became worthless and each partner deducted his distributive part of this loss, part of which was carried back to 1955 and/or 1956. Taxpayers contend that they sustained upon the abandonment of their interests in the joint venture in 1958 additional net operating losses that could be carried back to their 1956 tax years or for Martin carried forward to his tax years 1959 through 1962.

Congress enacted Subchapter K to deal with tax consequences of a partnership. If no part of any business, financial operation or venture of the partnership continues to be carried on by any of the partners in a partnership, the partnership is considered as terminated and the property remaining therein is deemed distributed to the partners. Where the distribution is money, any gain or loss upon the distribution is treated as a sale or exchange of a capital asset. The same rule applies even if there is no distribution. Accordingly, any loss is a capital loss. The loss is measured by the difference in the partner's basis and the amount, if any, received. To determine the basis one must know, inter alia, the amount contributed by the partner, his distributive share of the partnership's profits or losses, and the amount of any distributions to him.

In the instant case the taxpayers have failed to establish the amount of their bases. There is some indication that money was available for distribution in 1958, but there is no indication of how much was actually distributed in that or prior years.

Further, there is no indication of the initial contributions of the partners. Accordingly, taxpayers have failed to establish any factual basis that losses were in fact sustained by them in 1958 upon their alleged abandonment. Further, they err in contending that the loss is an ordinary loss. The effect of their legal contention is to ignore Subchapter K. Accordingly, the Tax Court correctly determined that taxpayers sustained no additional losses in 1958 which could be carried back or forward.

(3) The $250,000 payment

In 1956, the joint venture received $250,000 from General Tire in exchange for the joint venture's agreement not to oppose General Tire's take-over attempt of Byers, to sell General Tire its Byers stock, to refrain from purchasing Byers stock or securities for five years, and to assign General Tire the joint venture's proxy expenses incurred in an attempt to control Byers and a patent application, and treated the amount received as capital gains. The Commissioner determined that the amount was received for not opposing General Tire's acquisition of Byers and therefore was taxable as ordinary income. On brief in the Tax Court, the taxpayers also contended that the amount was for the option to sell Byers stock to General Tire. The Tax Court determined that the taxpayers had failed to show that the patent application had any value or that any part of the amount was given for the option or patent application. Accordingly, the Tax Court correctly sustained the Commissioner's determination. Taxpayers have failed to show that the Tax Court's determination was clearly erroneous.

(4) The retroactive allocation issue

The Commissioner concedes that he and the Tax Court erred in allocating to Martin two ninths of the joint venture's profits and losses realized in 1956 before he became a member of the joint venture. Such a determination violates such fundamental tax concepts as the assignment of income doctrine and the nonrecognition of profits and loss allocations for tax avoidance purposes. Accordingly, the decision of the Tax Court with respect to Martin's 1956 tax year should be remanded so that only two ninths of the joint venture's profits or losses realized after he became a member of the joint venture are included in computing his 1956 tax.

(5) The innocent spouse issue

Joint returns were filed by taxpayers and their wives in 1956. Accordingly, the wives are liable for any tax liability found to be due. Taxpayers' wives seek shelter from this liability under Section 6013(e) of the 1954 Code. That section relieves one spouse who has filed a joint return of any income tax liability with respect to an omission from gross income by the other spouse if the spouse claiming the relief shows (1) that there was in fact an omission from gross income attributable to the other spouse in excess of 25 percent of the amount stated in the return, (2) that she did not know and had no reason to know of such omission, (3) that she did not significantly benefit directly or indirectly from the items omitted from income, and (4) that it would be otherwise inequitable to hold her liable

for the tax attributable to such omission. The wives have failed to establish any of the requirements entitling them to relief under this section.

Taxpayers' contentions that a reduction in the cost of goods sold is an omission from gross income and that the joint venture's income was not to be considered in determining gross income run afoul of specific Congressional intent to the contrary. Their contention that the Tax Court abused its discretion in not reopening the record over one year after the trial to admit evidence on this issue is without merit. The issue was in the case before trial. And though at trial taxpayers tried to keep the record open for other purposes, they did not ask to do so for this issue. There is no evidence that the wives could not have testified at that time. Accordingly, the Tax Court correctly rejected their innocent spouse contention.

(6) <u>The disallowance of alleged business expenses of the joint venture in 1956 and 1957</u>

In determining taxpayers' distributive shares of the joint venture's profits or losses for 1956 and 1957, the Commissioner disallowed most of the sales, travel, legal, and accounting expenses and all the commission expenses claimed by the joint venture. The taxpayer introduced no evidence that such expenditures were actually incurred by the joint venture. Such proof is a prerequisite for an allocation under the rule enunciated in

Cohan v. Commissioner, 39 F. 2d 540 (C.A. 2, 1930). The Tax Court's decision sustaining the Commissioner's determination is clearly correct.

The Commissioner's Appeal

The Court need determine whether the joint venture had cancellation of indebtedness income in 1957 only if it determines that the joint venture had a bona fide unconditional obligation to pay Brisson $900,000 for Torbrook stock in 1956.

It is well settled law that a solvent taxpayer realizes income by reason of a forgiveness of his indebtedness where he received a tax benefit in a prior year by reason of such indebtedness. There is no evidence that the joint venture was not solvent in 1957. In a letter dated January 7, 1957, Brisson acknowledged payment of the $900,000 note by receipt of 200,000 shares of Torbrook stock. Taxpayers conceded that the shares were never delivered. If the $900,000 was in fact a bona fide cost of Torbrook stock in 1956 (and our basic contention is that all the correspondence with Brisson is fabricated), acknowledgement of a non-existent payment constitutes a forgiveness of indebtedness generating income for the joint venture in 1957.

The Taxpayers' Appeal

ARGUMENT

I

THE TAX COURT CORRECTLY FOUND THAT THERE WAS NO BONA FIDE UNCONDITIONAL OBLIGATION TO PAY BRISSON $900,000 FOR THE TORBROOK STOCK AND, ACCORDINGLY, CORRECTLY REDUCED THE JOINT VENTURE'S COST OF THAT STOCK BY THAT AMOUNT

On its 1956 return, the joint venture included in the cost of Torbrook stock $900,000 that it allegedly agreed to pay Brisson in 1956 for Torbrook stock. The Commissioner questioned the bona fides of this agreement that was purportedly evidenced by a non-interest bearing $900,000 note and disallowed the entire amount as a cost of Torbrook stock. The Tax Court found that there was no bona fide unconditional obligation to pay Brisson the sum of $900,000 and sustained the Commissioner's determination.

Included in the cost of property is any determinable amount that a taxpayer is unconditionally liable to pay. Crane v. Commissioner, 331 U.S. 1 (1947); Parker v. Delaney, 186 F. 2d 455 (C.A. 1, 1950); Sacramento Medico Dental Building Co. v Commissioner, 47 B.T.A. 315, 328 (1942), nonacq., 1942-2 Cum. Bull. 31; Redford v. Commissioner, 28 T.C. 773 (1957); Rev. Rul. 55-675, 1955-2 Cum. Bull. 567. The Commissioner's disallowance of the $900,000 cost item is presumptively correct, and the burden was upon the taxpayers to establish that there was an unconditional obligation to pay Brisson $900,000 for the Torbrook stock. Burnet v. Houston, 283 U.S. 223, 228-229 (1931); O'Neill v. Commissioner, 271 F. 2d 44, 50 (C.A. 9, 1959); 3A Mertens, Law of Federal

Income Taxation (Rev.), § 21.01, p. 13. The taxpayers failed to meet this burden. The Tax Court's factual finding that there was no unconditional obligation on the part of the joint venture to pay Brisson the sum of $900,000 is entitled to affirmance unless it is clearly erroneous. Rule 52(a), Federal Rules of Civil Procedure; Section 7482(a), Internal Revenue Code of 1954, Appendix, infra; Commissioner v. Duberstein, 363 U.S. 278, 290-291 (1960). Taxpayers have failed to show that the Tax Court's determination is clearly erroneous.

There is no evidence to show that the joint venture had a bona fide unconditional obligation in 1956 to pay Brisson $900,000 for Torbrook stock. In the first place, as the Tax Court noted, it was not established that Brisson had ever exercised his right to subscribe to one 500,000 shares of Torbrook purported to have been sold by him. Rather, the evidence indicates that there was no bona fide unconditional obligation to pay Brisson $900,000 in 1956. Taxpayers failed to authenticate any document showing that the joint venture had entered into an unconditional obligation to pay Brisson $900,000.[7/] (Op. 38-39.) Further, they were unable

7/ For lack of authentication, the documentary evidence was not admitted for the truth of the matter contained therein. (Tr. 333, 337, 410.) Taxpayers' Exhibit 42 (the alleged May, 1956, agreement between the joint venture and Brisson) was admitted as a document shown to the accountant (Elliott), who was not present when the agreement was allegedly entered into and whose knowledge of the transaction come from a perusal of the document itself. (Tr. 314-316, 318, 322, 324, 369.) Taxpayers' Exhibit 43 (the alleged amended agreement of November 3, 1956, between the joint venture and Brisson) was admitted for the limited purpose of showing that it was a document the accountant (Elliott) used to prepare the joint venture's informational return for 1956. (Tr. 322-324.) Although he

to explain how the original of the purported note (Exhibit 38) came to be in Sydney's files. Coupled with the fact that the taxpayer nowhere contend that the alleged note was paid, it would suggest that the alleged note was not in fact given.

Inferences that there was no unconditional obligation to pay Brisson $900,000 may be drawn from the fact that Walter, the member of the joint venture who withdrew on November 2, 1956, by sale of his interest therein to Sydney, Norman, and Robert, never knew of Brisson and was unaware of any obligation owed him by the joint venture. (Op. 17; Tr. 224.) Yet, taxpayers contend that on the following day (November 3) they entered into an agreement with Brisson to pay him $900,000 to terminate an alleged open-ended obligation to him and that this agreement was evidenced by executing a $900,000 note to Brisson. It is difficult to believe that a withdrawing member of a joint venture would not have had some knowledge of this transaction if it in fact took place. An additional inference that there was no bona fide obligation to Brisson may be drawn from the fact that Martin, who

7/ (continued)

recommended the revision of the purported May, 1956, agreement and prepared a suggested revision, he had no personal knowledge that the parties entered into this agreement. (Tr. 317, 319-321, 394.) Taxpayers' Exhibit 38 (the original of the alleged $900,000 note) was admitted into evidence for the sole purpose of showing that it was a document found in the files of Sydney Newman (Tr. 56-59, 368-371.) There is no evidence that it was ever delivered to Brisson.

"Tr." references are to the transcript of the hearing on October 10, 16, and 17, 1972.

became an active member of the joint venture on November 5, 1956, was also unaware of any significant obligations of the joint venture. (Op. 17; Tr. 268.) Finally, the accountant (Elliott), who had recommended the termination of the alleged open-ended agreement with Brisson and who helped work out the agreement under which Walter terminated his interest in the joint venture, was unaware of the purported November 3 agreement until the Spring of 1957. (Tr. 220, 317, 319-321.) This likewise would tend to show the non-existence of a bona fide unconditional obligation to Brisson.[8/]

Included in Sydney's effects at his death was a letter dated January 7, 1957, purportedly from Brisson acknowledging receipt of 200,000 shares of Torbrook stock in payment of the alleged $900,000 note. (Op. 16, 39.) Taxpayers, however, admitted that this misrepresented the facts and that the 200,000 shares of Torbrook stock were never delivered to Brisson. (Op. 16, 39.)

8/ An additional inference that there was no unconditional obligation to pay Brisson $900,000 arises from the fact that the only surviving member of the joint venture, as constituted on November 3, 1956, at the time of trial (and one of the taxpayers herein (Norman Rodman)) failed to appear and testify. Taxpayers offered a letter from a physician in Switzerland (Exhibit 48, admitted for identification only for it constituted hearsay (Tr. 202, 203, 352, 355)) to show why he was not present at the trial, but offered no reason why his testimony was not available by way of deposition as provided in Rule 45, Rules of Practice, United States Tax Court (Rev. 1958, 1971 ed.) (now Rules 80 and 81 under the Rules of Practice and Procedure of the United States Tax Court (Jan., 1974); see generally 9 Mertens, Law of Federal Income Taxation (Rev.), § 50.88). Though Judge Quealy opined that Norman's failure to appear did not raise any inference (Tr. 352), it is well established that "The law creates a presumption, where the burden is on a party to prove a material fact peculiarly within his knowledge and he fails without excuse to testify, that his

Their admission that this letter misrepresents the facts casts a shadow over the bona fides of the other documents upon which they rely and certainly supports the inference drawn by the Tax Court (Op. 39) that if there was an agreement between Brisson and the joint venture, any payment thereunder was wholly contingent.

Taxpayers attack the Tax Court's determination that there was no bona fide unconditional obligation to pay Brisson $900,000 for Torbrook stock by making assumptions not supported by any evidence in the record, by repudiating the stipulated facts as to the cost of Torbrook stock and by accusing the Commissioner of failing to follow certain well established legal principles. First, taxpayers rely upon facts in documents which were not admitted to show the truth of the facts contained therein because taxpayers were unable to authenticate them. Nor is there anything else in the record to support their assertion (Br. 6, 21) that the joint venture acquired 500,000 shares of stock from Brisson (Op. 10-11).

8/ (continued)

testimony, if introduced, would be adverse to his interests." Meier v. Commissioner, 199 F. 2d 392, 396 (C.A. 8, 1952); Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158, 1165 (1946), 9 Mertens, Law of Federal Income Taxation (Rev.), § 50.59. Since the burden of proof was upon the taxpayers to show that there was an unconditional obligation to pay Brisson $900,000 in 1956 for Torbrook stock and since taxpayers could have met this burden only by Norman's testimony, it must be presumed that his testimony would have been adverse to their position.

Their attempt to prove the existence of a $900,000 obligation to Brisson by circumstantial evidence based on cost comparisons of Torbrook stock to the joint venture (Br. 21-22) is contrary to the facts stipulated by the parties. The parties stipulated that the per share cost of Torbrook stock to the partnership for 1956 was $1.56582 aside from the amounts in dispute. (Stip. par. 9; Supp. Stip. par. 23.) Taxpayers' assertion (Br. 6, 21-22) that Sydney and various nominees paid $994,702.34 for 500,000 shares of the stock represents a unit cost far in excess of that stipulated. This assertion is premised upon allegations made by the Commissioner in pleading an affirmative defense of fraud in his answers (see paragraph 7(f) of the Answer in each case for 1956 and 1957 (T.C. Dkt. Nos. 5779-65 through 5786-65) and paragraph 7(c) of the Answer in Martin's cases for 1959 through 1961 (T.C. Dkt. No. 3737-67)). Taxpayers specifically denied such facts in their Replies. (In addition to the replies in each case, see also Tr. 387-389.) Since such allegation is contrary to the subsequent stipulation of the parties, it may not be considered. Henry v. Commissioner, 362 F. 2d 640, 643 (C.A. 5, 1966); Estate of Reeve v. Commissioner, 21 T.C.M. 611, 613 (1962); Tax Court Rule 31(b) (1971) (now Rule 91(e) of the 1974 Tax Court Rules); 9 Mertens, Law of Federal Income Taxation (Rev.), § 50.72.[9/] In any event, what Sydney and various nominees might have paid for

9/ The Tax Court recognized (Op. 10-11) that the facts relied upon by taxpayers were only unadmitted allegations because it noted that $994,702.34 is what Sydney and the various nominees were to have paid and not in fact what they did pay.

the Torbrook stock has no relevance to whether the joint venture entered into a bona fide unconditional agreement with Brisson to purchase Torbrook stock.10/

Finally, contrary to taxpayers' assertion (Br. 23-24), the Commissioner has not questioned in this case the legal principle that cost of goods sold includes an unconditional obligation to pay a determinable sum.11/ The issue here is whether there was such a bona fide unconditional obligation to pay a fixed sum. Indeed, Merlo Builders, Inc. v. Commissioner, 23 T.C.M. 185 (1964), upon which the taxpayers place such heavy reliance (Br. 23), is distinguishable from this case because the record therein disclosed that the taxpayers in fact had an unconditional obligation to pay a determinable sum for the property acquired. Here the record shows the contrary--a fact that taxpayers conveniently overlook. Since the Tax Court found as a fact that at no time

10/ It is interesting to note that in his answers in each case for 1956 and 1957 and in Martin's case for 1956 through 1961, the Commissioner also alleged that Brisson purchased no shares of Torbrook stock, but, rather, that the joint venture purchased them. Taxpayers choose to ignore this allegation.

11/ Time Oil Co. v. Commissioner, 258 F. 2d 237 (C.A. 9, 1958); and Wasatch Chemical Co. v. Commissioner, 313 F. 2d 843 (C.A. 10, 1963), upon which taxpayers rely (Br. 22), have no relevance for they deal not with the determination of the cost of goods, but, rather, with the issue whether an accrual basis taxpayer's delivery of its secured promissory note to the trustees of a qualified pension plan constitutes payment within the meaning of Section 404(a)(6) of the Code. They appear, in any event, to conflict with Eckert v. Burnet, 283 U.S. 140 (1931); Helvering v. Price, 309 U.S. 409 (1940); Jenkins v. Bitgood, 101 F. 2d 17 (C.A. 2, 1939); and Williams Co. v. Commissioner, 76-1 U.S.T.C., par. 9131 (C.A. 7, Dec. 16, 1975).

was there a definitive obligation to Brisson (Op. 16-17, 39), taxpayers' arguments based upon a contrary assumption have little bearing upon the case.

In sum, the taxpayers have failed to show the Tax Court's finding of no unconditional obligation on the part of the joint venture to pay Brisson $900,000 to be clearly erroneous. Accordingly, its determination must stand.

II

THE TAX COURT CORRECTLY DETERMINED THAT TAXPAYERS WERE ENTITLED TO NO LOSS IN 1958 FROM AN ALLEGED ABANDONMENT OF THE JOINT VENTURE THAT WOULD ENTITLE THEM TO NET OPERATING LOSS CARRY-BACK DEDUCTIONS IN 1956 AND ENTITLE MARTIN TO NET OPERATING LOSS CARRY-FORWARD DEDUCTIONS IN 1959, 1960, 1961, AND 1962

The taxpayers claim (Br. 11) that they abandoned their joint venture interests in 1958 and that this abandonment generated net operating losses that they were entitled to carry back to their 1956 taxable years and that Martin was entitled to carry forward to his 1959, 1960, 1961, and 1962 taxable years. At the Rule 155 Hearing, the Tax Court noted that there was no evidence in the record to show that their alleged abandonment of the joint venture in 1958 generated any net operating losses that could be carried back to their 1956 taxable years or carried forward to Martin's 1959, 1960, 1961, and 1962 taxable years. Further, the Tax Court commented that any losses upon the abandonment of an interest in a a joint venture would constitute a capital loss.

A joint venture is treated as a partnership for tax purposes Secs. 761(a) and 7701(a)(2), Internal Revenue Code of 1954, Appendix, infra. The adjusted basis of a contributing partner's interest consists of the amount of money contributed plus (a) the adjusted basis of any property contributed, (b) his distributive share of the partnership's taxable and exempt income for the taxable year and prior taxable years, and (c) the excess of the deductions for depletion over the basis of the property subject to depletion for the taxable year and prior taxable years, and less (but not below zero) (a) the distributions by the partnership, (b) his distributive share of losses of the partnership for the taxable year and prior taxable years, and (c) his distributive share of the expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account. Sections 705(a) and 722, Internal Revenue Code of 1954, Appendix, infra.[12/] "Any increase in a partner's share of the liabilities of a partnership or any increase in a partner's individual liability by reason of the assumption by such partner of partnership

12/ For a partner who acquires his interest in the partnership other than by contribution, the ordinary rules governing the acquisition of assets are generally applied to determine his beginning basis in the partnership (e.g., the basis of a purchased interest is its cost (Secs. 1011 and 1012 of the 1954 Code (26 U.S.C.)) and the basis of a donated interest is the adjusted basis of the interest in the hands of the donor plus the federal gift tax paid on the gift (Sec. 1015 of the 1954 Code (26 U.S.C.))). To arrive at his adjusted basis, the beginning basis is adjusted in accordance with Section 705(a).

Where it is impossible to determine a partner's basis in the partnership under the rule set forth above, Section 705(b) of the Code, Appendix, infra, provides an alternative method to compute the basis. Under this method, the adjusted basis of a partner's

liabilities, shall be considered as a contribution of money by such partner to the partnership." Sec. 752(a) of the Code (26 U.S.C.). "Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership." Sec. 752(b) of the Code (26 U.S.C.).

The cost basis to the joint venture of stock and stock options that it sold between 1955 through 1958 is capable of being calculated. However, there is nothing in the record (apart from the amount paid to the withdrawing partner in 1956) to demonstrate how much each of the joint venture members contributed to the joint venture. Further, even if we assume (as do taxpayers (Br. 24-26), contrary to the evidence) that the basis of each partner was zero in 1956, there is nothing in the record as to what distributions were made by the joint venture to its members. The taxpayers have failed to prove that they had any excess bases in their joint venture interests in 1958 that would constitute a net operating loss that could be carried back and/or forward. In sum, taxpayers have built a legal argument upon facts that simply

12/ (continued)

interest may be determined by reference to his proportionate share of the adjusted basis of partnership property which could be distributed upon termination of the partnership. Treasury Regulations on Income Tax (1954 Code), § 1.705-1(b), Appendix, *infra*.

do not exist.[13/] The Tax Court correctly held that there were no net operating losses in 1958 above those allowed by the Commissioner that could be carried back to 1956 or carried forward to subsequent years.

Even if the taxpayers were able to prove that they abandoned the joint venture and the existence of excess bases in 1958 in the joint venture, any loss sustained by them upon the abandonment of their partnership interests would constitute a capital loss. Section 708(b)(1) of the Code, Appendix, _infra_, provides that a partnership shall be considered as terminated if "no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership." The Treasury Regulations on Income Tax (1954 Code), Section 1.708-1(b)(1)(iv), Appendix, _infra_, provide that if a partnership is considered as terminated, the partnership properties are regarded as distributed to the partners. Willis on _Partnership Taxation_, p. 312. Section 731(a) of the Code, Appendix, _infra_, provides that in the case of a distribution by a partnership to a partner, gain shall be recognized to the extent that the money

---

13/ Where records are not available to prove bases, Section 1.705-1(b) of the Regulations suggests the use of the alternative method to compute the bases. See fn. 12, _supra_. If one takes the figures on the partnership returns and adjusts them by the stipulations of the parties and the opinion of the Tax Court, it would still be difficult on this record to determine the bases of the members in the joint venture under the alternative method. If one assumes that all of its assets were disposed of during its 1958 taxable year and that all loans were collected or paid, then it would appear that taxpayers' bases in the joint venture at the end of 1958 would be zero under the alternative method.

distributed exceeds the adjusted basis of such partner's interest and loss shall be recognized upon a distribution in liquidation of a partner's interest (where no property other than money, unrealized receivables and inventory is distributed) to the extent that the partner's interest in the partnership exceeds the amount of money, unrealized receivables and inventory distributed. Section 731(a) further provides that "Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." Since a partner's interest in the partnership is treated as a capital asset (Sec. 741, Appendix, infra), the gain or loss is treated as a capital gain or capital loss. See, e.g., Stackhouse v. United States, 441 F. 2d 465 (C.A. 5, 1971); Pietz v. Commissioner, 59 T.C. 207 (1972); Willis on Partnership Taxation, pp. 338-339.

In the instant case, the Commissioner has conceded that the Torbrook stock which the joint venture held became worthless in 1958. For 1958, the joint venture reported $92,521.11 in long-term capital gains on its return. If the partnership used this money to pay its expenses reported on its 1958 return (Ex. 24-X), there would have been some amount available for distribution. There is no evidence that some cash was not distributed or available for distribution. Since the Regulations deem such money distributed, any resulting gain or loss would result in a capital gain or loss.

Finally, if there was nothing for distribution, any resulting loss would be a capital loss. There is no economic difference between the situation in which a partner receives no distribution whatever upon a termination of the partnership and the situation in which he receives only a nominal sum. If he were to receive a one cent distribution, there is no question that any loss would be a capital loss. A zero distribution should produce the same result. See Little, Federal Income Taxation of Partnership (1952) (1957 Supp.), pp. 154-155.

The taxpayer argues that if there is no distribution, there can be no sale or exchange. Accordingly, any loss upon the termination of a partnership without a distribution would constitute an ordinary loss deductible under Section 165(c)(1) of the Code, Appendix, *infra*. With the exception of Zeeman v. United States, 275 F. Supp. 235 (S.D. N.Y., 1967), aff'd and remanded on other issues, 395 F. 2d 861 (C.A. 2, 1968), the authorities upon which taxpayer relies (Br. 25) are inapposite. Gannon v. Commissioner, 16 T.C. 1134 (1951), acq. 1951-2 Cum. Bull. 2, and Hutcheson v. Commissioner, 17 T.C. 14 (1951), acq. 1951-2 Cum. Bull. 2, were decided under the Internal Revenue Code of 1939, which did not contain the restrictions on partnerships of the 1954 Code. See Stilwell v. Commissioner, 46 T.C. 247 (1966). As for Rev. Rul. 70-355, 1970-2 Cum. Bull. 51, and Rev. Rul. 66-93, 1966-1 Cum. Bull. 165, the Internal Revenue Service only permitted limited partners to take an ordinary loss up to the amount of their bases because of business losses suffered by the partnership. This

was nothing more than permitting them to deduct their distributive share of the losses under Section 702 of the Code, Appendix, <u>infra</u>.

We acknowledge that the District Court's opinion in <u>Zeeman</u> is contrary to the position taken by the Commissioner herein. On the taxpayer's appeal in that case, this Court noted that the Government did not appeal this issue and accordingly did not disturb the District Court's conclusion. The District Court premised its decision upon the Tax Court's decision in <u>Gannon</u>, which in turn was based upon the predecessor of Section 165(c)(1) of the 1954 Code. To determine the loss, the Court should have applied the provisions of Subchapter K rather than Section 165(c)(1). While Section 165(a) of the Code, Appendix, <u>infra</u>, permits a deduction for losses incurred in the partnership's trade or business, which losses may be taken into account by the partners under Section 702 of the Code, neither Section 165(a) nor Section 165(c)(1) permits a loss resulting from the loss of a partnership interest. Rather, as pointed out above, Section 731 provides for the recognition of a loss from the liquidation of any partner's interest in the partnership, but provides that it shall be treated as a sale or exchange, giving rise to a capital loss. This provides the same treatment for partnership interests that Section 165(g) provides for worthless securities. A contrary interpretation would permit the partners to avoid the provisions of Subchapter K, which was enacted specifically to deal with partnerships, and would introduce a differentiation, for which no reason

appears, between a worthless partnership interest and a worthless security.

III

THE TAX COURT CORRECTLY SUSTAINED THE COMMISSIONER'S DETERMINATION THAT THE $250,000 RECEIVED BY THE JOINT VENTURE FROM GENERAL TIRE WAS ORDINARY INCOME

During 1955, the joint venture engaged in a proxy fight with General Tire to acquire control of Byers. Though the joint venture lost, it incurred a total of $380,677.23 in proxy expenses. In July, 1956, General Tire and the joint venture entered into an agreement designed primarily to permit General Tire to acquire Byers without opposition from the joint venture. For $250,000, the joint venture assigned its claim for proxy expenses and its rights to a patent application to General Tire, gave its promise not to acquire any Byers stocks or securities for a period of five years or otherwise interfere with General Tire's attempt to take over Byers, and gave an option to General Tire for the Byers stock that the joint venture owned.[14/]

On its 1956 informational return, the joint venture treated the $250,000 received from General Tire as capital gain from the sale of a patent. In their brief in the Tax Court, the taxpayers further contended that the amount was also received for an option given General Tire to purchase the joint venture's Byers stock.

14/ In General Tire's registration statement (p. 6) filed with the Securities and Exchange Commission in preparation of its offer mentioned in its agreement with the joint venture, General Tire stated that the primary purpose of its agreement with the joint venture was the agreement to deposit shares and not oppose the offer.

The Commissioner determined that the payment was for termination of the joint venture's attempt to gain control of Byers and to extinguish the joint venture's claim against Byers for proxy expenses that the joint venture incurred in attempting to gain control of Byers. Accordingly, he treated the amount as ordinary income. The Commissioner's determination is presumptively correct and the taxpayers have the burden of showing that the $250,000 constituted the receipt from the sale or exchange of a capital asset. They have failed to show what part, if any, of the $250,000 constituted the receipt from the sale of a capital asset. The Tax Court's factual determination sustaining the Commissioner's determination comes to this Court under the clearly erroneous rule. Thompson v. Commissioner, 406 F. 2d 1006, 1008, 1010 (C.A. 9, 1969); Kunz v. Commissioner 333 F. 2d 556 (C.A. 6, 1964).

Taxpayers failed to prove that the patent application had any value. At the time the agreement was entered into, the patent application had been rejected and no amendment had then been filed. When a patent application has been rejected, there arises a presumption that the invention is unpatentable. See Fraser v. Kent, 194 App. Div. 742, 185 N.Y.S. 746 (1921). In view of this presumption, the patent application could hardly have been worth much, if anything. (In the following year the patent application was forfeited for failure to pay the final filing fees.) Further, there is no indication that the joint venture owned 25,000 shares of Byers stock, as taxpayers allege. (Br. 27.) Rather, the agreement itself noted that the joint venture owned or controlled

25,000 shares. (Ex. 26-Z.) The joint venture certainly had no right to sell stock for which it had proxies. It is just as plausible that General Tire paid the joint venture not to oppose its offering. Since taxpayers have failed to prove what part, if any, of the $250,000 payment was for the option to purchase its Byers shares and for the rights to the patent application, the Tax Court had no choice but to sustain the Commissioner's determination that the $250,000 received by the joint venture from General Tire was taxable as ordinary income. F. & D. Rentals, Inc. v. Commissioner, 365 F. 2d 34 (C.A. 7, 1966), cert. denied, 385 U.S. 1004 (1967); Kunz v. Commissioner, supra.[15/]

Taxpayers assert that the Tax Court erred because no allocation was necessary since the entire amount was paid for an option and/or for the rights to the patent application, either of which would entitle it to capital gain treatment. Taxpayers' conclusion is again based on facts not in the record, and ignores those facts that are in the record. Further misplaced is their reliance upon Section 1235(a) of the Internal Revenue Code of 1954, Appendix, infra, which gives capital gain treatment upon the transfer of all substantial rights to a patent. Section 1.1235-2, Treasury Regulations on Income Tax (1954 Code), Appendix, infra, provides that only such substantial rights to the patent which are of value at the time of the transfer come

15/ This Court has remanded where there is evidence that some allocation is required. Kurlan v. Commissioner, 343 F. 2d 625 (1965), and cases cited therein. Those cases are inapplicable here because the taxpayers have failed to produce any evidence requiring an allocation.

within the purview of Section 1235. There is nothing in the record as to the value of any of the rights in this patent application. Finally, taxpayers' contention that the $250,000 payment was for an option to purchase the joint venture's Byers shares was untimely raised and therefore not properly before the Tax Court. That issue was raised for the first time on brief. It is well settled that new issues may not be raised for the first time on brief in the Tax Court. Robertson v. Commissioner, 55 T.C. 862, 865 (1971); Messer v. Commissioner, 52 T.C. 440, 455 (1969).

In sum, there is no error in the Tax Court's finding on this issue.

IV

THE TAX COURT INCORRECTLY DETERMINED THAT MARTIN RODMAN WAS TAXABLE ON INCOME EARNED PRIOR TO HIS BECOMING A MEMBER OF THE JOINT VENTURE

At the end of the joint venture's 1956 tax year, Sydney had a one-third interest, and Robert, Norman, and Martin each had a two-ninths interest therein. For that year, the joint venture reported on its informational return a net loss, which was allocated to the partners in accordance with their respective interests.[16/] Because of other adjustments made by the Commissioner

16/ Two ninths of the profits realized (after subtracting that part allocable to the joint venture member who withdrew) from the General Tire deal was allocated to Martin and reported by him on his return. The Commissioner concedes that none of this profit should have been allocated to Martin for it was realized prior to the time that he entered the partnership.

and sustained by the Tax Court, the loss was converted into a profit. The Commissioner determined that two ninths of this profit was includable in Martin's income on the ground (a) that Martin had in fact been a member of the joint venture for the entire year, (b) that Martin had been allocated all of the loss or profit of the joint venture after he became a member in November 5, 1956, up to the maximum of two ninths of the joint venture's profit or loss for the entire year, or (c) that the members of the joint venture had in fact amended the partnership agreement to give Martin a two ninths interest in the joint venture's profit or loss for the entire year. In his amended petition, Martin claimed that he was entitled to two ninths of the joint venture's profit or loss realized after he became a member.

The Tax Court determined that Martin became a member of the joint venture on November 5, 1956, and that the members of that venture had in fact allocated to Martin two ninths of the partnership's profit and loss for the entire year after allocating 25 percent of the joint venture's Section 702(a) items for the period ending November 2, 1956, to Walter (the partner who withdrew) under Section 706(c)(2)(A) of the 1954 Code (26 U.S.C.). The Tax Court reasoned that pursuant to Sections 704(a) and 761(c) of the Code, Appendix, <u>infra</u>, a joint venture could retroactively allocate to the beginning of any year its profits and losses to a partner who was not a member for the entire year. (Op. 44-46.)

The Commissioner agrees with the taxpayer that the Tax Court erred in holding that a joint venture agreement could be amended at the end of the year to allocate to a partner who became a member during the year profits and losses realized prior to his becoming a member thereof. As we pointed out earlier, a joint venture is treated as a partnership for tax purposes. The partnership is not the entity upon which tax is imposed. Rather, the partner's distributive share of the partnership's profit or loss is included in the computation of the partner's tax liability. See Secs. 701 and 702 of the Code. "A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement." Sec. 704(a) of the Code. See also, United States v. Basye, 410 U.S. 441, 454 (1973). Under Section 761(c), the distributive shares may be reallocated at the end of the partnership year. Such reallocation relates back to the beginning of the year at least where the partners have been associated with the partnership for the entire year. Smith v. Commissioner, 331 F. 2d 298, 301 (C.A. 7, 1964). However, the privilege of permitting members of a partnership to agree among themselves to allocate profits and losses is subject, *inter alia*, to (1) the statutory limitation that the principal purpose of the allocation is not the avoidance or evasion of tax (under Section 704(b) of the Code, Appendix, *infra*, and the limitation under the general law principles of the nonrecognition of an allocation of income and losses whose principal purpose is tax avoidance or

evasion (see § 1.704-1(e)(1)(i) of the Treasury Regulations on Income Tax (1954 Code), Appendix, infra; Trounstine v. Commissioner, 18 T.C. 1233, 1239 (1952); Haas v. Commissioner, 55 T.C. 43, 50 (1970)))[17/] and (2) the disallowance of losses in excess of basis until such losses are repaid to the partnership (Sec. 704(d) of the Code, Appendix, infra). Where profits or losses are realized prior to the entry of a partner into a partnership, an allocation to the incoming partner of such profits or losses would, as a matter of law, be an allocation whose principal purpose was tax avoidance or evasion.

Further, the scheme of the partnership provisions suggests that there should in general be no retroactive allocation of gains and losses to the beginning of the taxable year for a partner who becomes a member during the year. If a new partner receives more than a 50 percent interest in the partnership, there can be no retroactive allocation because the partnership is deemed to have terminated upon a shift in ownership of 50 percent. Sec. 708 of the Code. If a partner disposes of less than his entire interest, it would appear that there would be no allocation of prior realized profits or losses to a new partner because Section 706(c)(2)(B) provides that the "partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the

17/ The retroactive allocation of income would also run afoul of fundamental assignment of income principles. See, e.g., Helvering v. Horst, 311 U.S. 112 (1940); Rev. Rul. 58-275, 1958-1 Cum. Bull. 22; Surrey and Warren, Federal Income Taxation (1962 ed.), pp. 962-963.

taxable year." Where the new partner purchases the entire interest of the withdrawing partner, Section 706(c)(2)(A) provides that the tax year of the partnership is closed with respect to the selling partner, who is then to include his pro rata share of the losses and profits to the date of the sale. The new partner is to include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership's taxable year.[18/] In sum, if there can be no retroactive allocations of income and losses in these instances, there would appear to be no justification to allow a retroactive allocation in the instant case. See McGuire, Retroactive Allocations Among Partners: The Rodman Decision, 52 Taxes 325 (1974).

Accordingly, Martin should include as his distributive share of the joint venture's profits and losses, two ninths of the profits and losses realized after he become a member of the joint venture.

18/ By prorating losses or profits by the number of days that the selling and purchasing partners held their respective interests, there could be some retroactive allocation of profits or losses where there was substantial income during the period that the selling partner was a member of the partnership and there were substantial losses during the period that the purchasing partner was a member. The Treasury Regultions on Income Tax (1954 Code), Section 1.706-1(c)(2), Appendix, infra, permit such an allocation for administrative convenience.

V

THE TAX COURT CORRECTLY DETERMINED THAT THE TAXPAYERS' WIVES WERE NOT INNOCENT SPOUSES IN 1956 UNDER SECTION 6013(e), INTERNAL REVENUE CODE OF 1954

Joint returns were filed by taxpayers and their wives in 1956. Under Section 6013(d)(3), Internal Revenue Code of 1954, Appendix, infra, individuals filing a joint income tax return are jointly and severally liable for any tax liability found to be due. Taxpayers' wives seek shelter from liability for the deficiencies in tax determined with respect to 1956 under Section 6013(e) of the Code, Appendix, infra (popularly known as the "innocent spouse" provision). That section relieves one spouse who has filed a joint return of any income tax liability with respect to an omission from gross income by the other spouse if the spouse claiming the relief shows (1) that there was in fact an omission from gross income attributable to the other spouse in excess of 25 percent of the amount stated in the return, (2) that she (or he) did not know or had no reason to know of such omission, (3) that she (or he) did not significantly benefit directly or indirectly from the items omitted from income, and (4) that it would be otherwise inequitable to hold her (or him) liable for the tax attributable to such omission. The burden of proof is upon the person claiming the benefits of this section. H. Rep. No. 91-1734, 91st Cong., 2d Sess., p. 3; S. Rep. No. 91-1537, 91st Cong., 2d Sess., p. 3 (1971-1 Cum. Bull. 606, 607); Allen v. Commissioner, 514 F. 2d 908, 912 (C.A. 5, 1975);

Sonnenborn v. Commissioner, 57 T.C. 373, 380-383 (1971). The wives have failed to establish any of the requisites for relief under this section.

The first requirement is that there must be an omission from gross income attributable to the other spouse in excess of 25 percent of the amount stated on the return. Section 6013(e)(2)(B) of the Code incorporates the rules of Section 6501(e)(1)(A) of the Code, Appendix, infra, to determine the amount omitted from gross income. Estate of Klein v. Commissioner, 63 T.C. 585 (1975), pending on appeal to this Court (No. 75-4251). See also § 1.6013-5(a)(2), Treasury Regulations on Income Tax (1954 Code), Appendix, infra. Section 6501(e)(1)(A)(i) specifically provides that an error in the cost of goods sold is not an omission of an item from gross income. See Colony, Inc. v. Commissioner, 357 U.S. 28 (1958); Allen v. Commissioner, supra; Resnick v. Commissioner, 63 T.C. 524 (1975). Further, the House and Senate Committee Reports provide (H. Rep. No. 91-1734, supra, p. 3; S. Rep. No. 91-1537, supra, p. 3 (1971-1 Cum. Bull., p. 607):

> Whether or not an omission meets this test is to be determined in a manner similar to the test applied under existing law in determining, for purposes of the 6-year statute of limitations [Section 6501(e)(1)(A)], when an omission in excess of 25 percent of gross income exists.

For the purpose of determining whether an omission under the six-year statute existed, the amount and characterization of "gross income" on the partnership level were determinative at the time Section 6013(e) was enacted in 1971 and are still determinative of gross income on the partner level. Secs. 61(a)(13) and

and 702(b) and (c), Internal Revenue Code of 1954, Appendix, infra; §§ 1.61-13(a) and 1.702-1(c)(2), Treasury Regulations on Income Tax (1954 Code), Appendix, infra; Davenport v. Commissioner, 48 T.C. 921, 928 (1967); Rose v. Commissioner, 24 T.C. 755, 768-769 (1955). Sections 61(a)(13) and 702(c) of the Code specifically provide that for the purposes of the Internal Revenue Code the gross income of a partner includes his distributive share of the gross income of the partnership. And Section 1.702-1(c)(2) of the Treasury Regulations and the House and Senate Committee Reports to the 1954 Code (H. Rep. No. 1337, 83d Cong., 2d Sess., p. A222 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4362); S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 168, 378 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4802, 5019)) likewise provide that for the purposes of Section 6501(e), the gross income of a partner includes his distributive share of the gross income of the partnership.[19/] In accordance with the Congressional mandate and the Treasury Regulations, the same rule is applicable here.

19/ The House Committee Report, supra, provided (p. A222):

Subsection (c) makes clear that, whenever the gross income of a partner is to be determined, such amount shall include his distributive share of the partnership gross income. For example, a partner is required to include his distributive share of partnership gross income in determining his individual gross income for the purposes of determining the necessity of filing a return, the application of the provision permitting the spreading of income for services rendered over a 3-year period, the amount of gross income received from possessions of the United States, and whether the extended period of limitation provided in the case of 25-percent omission from gross income is applicable. (Emphasis supplied.)

Since there was no omission in the amount of gross income, but only an overstatement of the cost, the first requirement has not been met. With respect to the other requirements, the taxpayers' wives have produced no evidence. Accordingly, the Tax Court correctly concluded that they were not entitled to the benefits of the innocent spouse section.

Taxpayers' wives attempt to avoid the result reached by the Tax Court and contend that error was committed in its determination of what constituted gross income under Section 6013(e), in its reading the partnership return as an adjunct to the joint return in determining gross income, and in its refusal to open the record over a year after the trial to accept evidence on this issue. These contentions are without merit.

19/ (continued)

The Senate Committee Report, supra, stated (p. 378):

> Subsection (c) relates to the determination of a partner's share of the gross income of a partnership. It will be noted that section 61(a), which defines gross income has been amended by your committee to make clear that a partner's gross income includes his distributive share of partnership gross income. However, under subsection (c), the determination of a partner's share of the gross income of the partnership need not be made annually, but only where the determination of the partner's individual gross income is required for income tax purposes. For example, a partner is required to include his distributive share of partnership gross income in computing his individual gross income for the purpose of determining the necessity of filing a return. A partner's gross income may also be relevant for other tax purposes, such as the application of the provision permitting the spreading of income for services rendered over a 3-year period (section 1301), the amount of gross income received from possessions of the United States, and the extended period of limitations applicable to deficiencies where there has been an omission of 25 percent of gross income. (Emphasis supplied.)

Section 6013(e)(2)(B) refers to all of Section 6501(e)(1)(A) to determine whether there has been an omission from gross income. Before it can be determined whether an amount is omitted from gross income under Section 6501(e)(1)(A)(ii), it must first be determined what is gross income, which Section 6501(e)(1)(A)(i) does in part. If subpart (i) is ignored for purposes of Section 6013(e), as taxpayers' wives suggest, there could be a divergency of determining the amount omitted under Section 6501(e)(1)(A) and Section 6013(e)--a result contrary to that intended by Congress. In addition, the Supreme Court in Colony, Inc., under the predecessor of Section 6501(e)(1)(A) (which did not have the provisions of Section 6501(e)(1)(A)(i)) and the Fifth Circuit in Allen (upon which taxpayers' wives rely (Br. 45)) under Section 6013(e)(1)(A) (and without reference to Section 6501(e)(1)(A)), reached the same result as that required by Section 6501(e)(1)(A)(i) that an understatement of income because of an overstatement of some item on the return or because of other adjustments to items reported on the return did not amount to an omission of income. Under their first attack on the Tax Court's decision, the taxpayers' wives request this Court not only to ignore the statutory language, but also to ignore Congressional intent and the judicial gloss put upon the two statutes involved.

Equally contrary to the statute and Congressional intent, is their contention that the partnership return was not to be read with the individual partner's return. As noted above, Sections 61(a)(13) and 702(c) specifically provide that for purposes of the Internal Revenue Code the gross income of a partner includes his distributive share of gross income of the partnership. In addition, Congress clearly stated that the test for determining an omission under Section 6013(e) was to be similar to that applied under existing law in Section 6501(e)(1)(A). Existing case law under that section required that the partnership return be read as an adjunct to the partner's return to determine gross income. Further, taxpayers' wives' suggestion that the cases involving partnership returns under Section 6501(e)(1)(A) are not applicable under Section 6013(e) (Br. 41-45) rests upon the untenable position that the partner's spouse does not have the right to see the partnership's return. The execution of a joint return is entirely elective. If the return shows partnership income, as was the case here, the decision whether to inquire further into the compulation of this income before executing a joint return is a matter of choice by the electing spouse.

With respect to their attack on the Tax Court's refusal to open the record for additional evidence, it is well established that "A motion to reopen and hear further evidence is addressed to the sound discretion of the Tax Court, and a denial of such a motion will not be reversed on appeal in the absence of extraordinary circumstances showing a clear abuse of discretion." Estate of Melcher v. Commissioner, 476 F. 2d 398, 400 (C.A. 9, 1973). Also see Dietrich v. United States Shipping Board E. F. Corp., 9 F. 2d 733, 745-746 (C.A. 2, 1925), cert. denied, 278 U.S. 647 (1928); Bankers Coal Co. v. Burnet, 287 U.S. 308, 313 (1932). Taxpayers' wives have shown no abuse of discretion here. The innocent spouse issue was raised by taxpayers' wives for tax years 1957 and 1960 in amended petitions that were filed either on April 14, 1972 (T.C. Dkt. Nos. 5780-65, 5781-65, 5785-65, 3737-67) or on April 20, 1972 (T.C. Dkt. No. 5784-65).[20/] In his opening remarks at the trial on October 10, 1972, taxpayers' counsel mentioned the innocent spouse question for 1957 and 1960. (Tr. 23-24.) But no evidence was offered on this point, no reason was given why the wives could not testify, and no request was made to keep the record open on this point. On October 31, 1973 (over a

---

20/ The taxpayers' wives did not raise the issue in their pleadings with respect to 1956, although they filed amended pleadings for that year on April 14, 1972, or April 20, 1972. (T.C. Dkt. Nos. 5779-65, 5782-65, 5783-65, 5786-75.) In their motion to reopen the record for additional evidence and in the Commissioner's opposition thereto, every Tax Court docket number, including those for 1956, was listed. The Tax Court assumed that the wives had raised the issue for every year before it. (Op. 8.) The arguments with respect to the innocent spouse issue assume that the issue was properly raised for 1956.

year after the trial), taxpayers requested that the record be opened for testimony on the issue and gave as the reason for delay that their wives "were either unavailable, sick, or aged" at the time of trial. (Mot. par. 2.) If this were the case, why did the taxpayers' counsel not mention these facts at the trial? He did several times attempt to show why one of the taxpayers could not be present at the trial and sought to have the record kept open to introduce evidence as to why he could not be present. (Tr. 47, 202-206, 352.) Further, taxpayers did not produce any affidavits from the wives to support the allegations in the motion. Indeed, if the wives were aged in October, 1972, they were even older in October, 1973. It is indeed strange that all four wives were not available at the time of trial. In addition, the trial court should expect a case to be presented at one time, and not piecemeal. Trials have to end at some time. The taxpayers' counsel had six months from the time that the issue formally came into the case and over eighteen months from the time that the statute was enacted to get evidence on this point prior to trial. Under all of these facts and circumstances, the Tax Court quite obviously did not abuse its discretion in refusing to reopen the trial for further evidence.

In sum, the Tax Court correctly determined that the wives were not entitled to innocent spouse status.

VI

THE TAX COURT CORRECTLY DETERMINED THAT TAXPAYERS FAILED TO ESTABLISH THE DEDUCTIBILITY OF CERTAIN ALLEGED BUSINESS EXPENSES BEYOND THE AMOUNTS ALLOWED BY THE COMMISSIONER

In computing its income for 1956, the joint venture deducted $124,804.19 as sales expenses and $9,445.56 as travel and investigation expenses. The Commissioner disallowed the alleged sales expenses and $6,685.73 of the alleged travel and investigation expenses for lack of substantiation. In computing its income for 1957, the joint venture deducted $40,793.90 as sales expenses, $7,688.98 as travel and investigation expenses, $2,700 as commissions and $64,053.88 as legal and accounting expenses. The Commissioner disallowed $40,276.38 of the alleged sales expenses, $61,117.88 of the alleged legal and accounting expenses and all of the alleged commissions and travel investigation expenses for lack of substantiation. (Op. 27-30, 42-43.) The result of these disallowances was to increase the joint venture's members' distributive shares of the profits in 1956 and decrease the joint venture's members' distributive shares of the losses in 1957.

It is settled law that deductions are a matter of legislative grace and that the taxpayer must prove his entitlement to them. See, e.g., New Colonial Co. v. Helvering, 292 U.S. 435, 440 (1934); Welch v. Helvering, 290 U.S. 111, 115 (1933). Because the taxpayers produced no evidence that such amounts were in fact incurred in connection with the joint venture's business, the Tax Court sustained the Commissioner's disallowances. (Op. 27-30, 42-43.)

Taxpayers assume (Br. 46-48) that the joint venture's receipt of $2,574,903.34 in 1956 and of $160,301.97 in 1957 entitles it as a matter of law to the deduction of some of these alleged outlays as ordinary and necessary business expenses under Section 162(a) of the 1954 Code, Appendix, _infra_, and the rule enunciated in _Cohan_ v. _Commissioner_, 39 F. 2d 540 (C.A. 2, 1930). This is not the case, however. Proof of an expenditure and of the business relationship of that expenditure has always been a condition precedent to the allowance of a business expense deduction. _Cohan_ v. _Commissioner_, _supra_; _Kelsey_ v. _Commissioner_, 27 T.C.M. 337, 341-344 (1968), aff'd _per curiam_, 69-2 U.S.T.C., par. 9619 (C.A. 2, Apr. 24, 1969); _Hearn_ v. _Commissioner_, 36 T.C. 672 (1961), aff'd, 309 F. 2d 431 (C.A. 9, 1962), cert. denied, 373 U.S. 909 (1963); _Williams_ v. _United States_, 245 F. 2d 559 (C.A. 5, 1957). Indeed, this Court in _Cohan_ emphasized that taxpayer must establish that the alleged expenditures were in fact made and that such expenditures were proximately connected with the business before the trier of fact need estimate their amount.

In the instant case taxpayers attempted to meet their burden of showing that expenditures were made, and of connecting the alleged expenditures to the joint venture's business, through the testimony of the accountant who supervised the preparation of the joint venture's tax returns. The accountant testified that he or his firm required documentation when they prepared income tax returns and that he or his firm received whatever documentation they thought necessary to prepare the return. (Tr. 302-303, 305-

313, 321.) However, the accountant was unable to testify from his own knowledge that any of the amounts claimed represented bona fide expenditures, or were in fact spent in connection with the business. The accountant never even commented with respect to his own charges for work done for the joint venture, much less commented that the amount allowed by the Commissioner was inadequate. The Tax Court specifically asked about certain alleged expenditures (Tr. 314), but there was no response from the accountant. In sum, all the accountant testified to was that he believed what the taxpayers told him and that the returns prepared by him were correct. If such testimony were sufficient to meet a taxpayer's burden of proof, there would be no need for the Commissioner to audit returns prepared by accountants or for the courts to try such cases.[21/]

In sum, the taxpayers have failed to meet their burden of proof in the Tax Court with respect to these alleged expenditures and of showing that the Tax Court's decision with respect to these alleged expenditures is clearly erroneous.[22/]

21/ The fact that the records of the joint venture are lost, that the persons involved are dead, or that the taxpayer has no other evidence to meet his burden of proof does not excuse the taxpayer from his burden of proof. Burnet v. Houston, supra, 283 U.S., p. 228; Hague Estate v. Commissioner, 132 F. 2d 775, 776 (C.A. 2, 1943), cert. denied, 318 U.S. 787 (1942).

22/ Martin testified with respect to travel done for Torbrook in 1956 and about Calgary expenses. (Tr. 262, 270.) A part of the travel expenses claimed and the Calgary expenses were allowed by the Commissioner. (Stip. par. 12.) Martin did not testify that this allowance was inadequate.

The Commissioner's Appeal

ARGUMENT

IF THE JOINT VENTURE HAD A VALID INDEBTEDNESS OF $900,000 TO BRISSON FOR WHICH IT RECEIVED A TAX BENEFIT IN 1956, IT REALIZED INCOME IN THAT AMOUNT IN 1957 WHEN THE DEBT WAS FORGIVEN

This Court need reach the issue presented on the Commissioner's appeal only if it determines that the Tax Court was in error, and that the joint venture had a valid indebtedness of $900,000 to Brisson for Torbrook stock. In that event, the Commissioner contends that this debt was forgiven in 1957 and that the joint venture had discharge of indebtedness income in 1957 in the amount of $900,000, the distributive shares of which are includible in taxpayers' incomes.

To protect the revenue, the Commissioner determined that if he in fact erred in reducing the joint venture's cost of Torbrook stock by $900,000, then the joint venture had income from discharge of indebtedness in 1957 in that amount, and in turn based part of his 1957 deficiency determinations upon this premise. Though it was an alternative to the deficiency in 1956, the Commissioner's determination that there was discharge of indebtedness income in 1957 was entitled to the presumption of correctness, and the burden was upon taxpayers to show no discharge of indebtedness income. Meyer v. Commissioner, 46 T.C. 65, 82-83 (1966), vacated and remanded in part, 383 F. 2d 883 (C.A. 8, 1967). The finding of no unconditional obligation to pay the $900,000 in 1956 of course eliminated this part of the 1957 deficiencies. However, if this Court determines that the Tax Court erred as to

1956, then, on this record, the taxpayers have clearly failed to show that there was no cancellation of indebtedness.

In a letter dated January 7, 1957, Brisson acknowledged receipt of 200,000 shares of Torbrook stock in full payment of the $900,000 note.[23/] (Op. 16; Pet. Ex. 34.) Since the parties have stipulated that taxpayers did not give Brisson 200,000 shares of Torbrook stock in 1957, the note was obviously cancelled for no consideration.

It is well settled law that a solvent taxpayer realizes income by reason of a forgiveness of his indebtedness where he received a tax benefit in a prior year by reason of such indebtedness. Sec. 61(a)(12), Internal Revenue Code of 1954, Appendix, _infra_; _Commissioner_ v. _Jacobson_, 336 U.S. 28 (1949); _United States_ v. _Kirby Lumber Co_., 284 U.S. 1 (1931); _B. F. Avery & Sons, Inc_. v. _Commissioner_, 26 B.T.A. 1393 (1932), pet. for review dismissed, 67 F. 2d 985 (C.A. 6, 1933); 2 Mertens, _Law of Federal Income Taxation_ (Rev.), §§ 11.19-11.22. There is no evidence that the joint venture or any of its members were insolvent in 1957. Accordingly, if the Torbrook stock's cost included

23/ This letter was admitted for the limited purpose of showing that it was a document found in the effects of Sydney Newman (Tr. 56; Op. 16) and not to show the truth of the facts contained therein. As pointed out above (pp. 22-23), the documents upon which taxpayers rely were also admitted for limited purposes and not to show the truth of the facts set forth therein. If this Court relies upon these documents, upon which the taxpayers rely, for the truth of the facts set forth in them, there would be no basis to ignore the facts in this letter of January 7, 1957, to the extent that they do not conflict with the stipulation of the parties. Even without this letter, the Commissioner would still be entitled to prevail because of the taxpayers' failure to meet their burden of proof of showing no cancellation of indebtedness.

a $900,000 obligation to Brisson in 1956, acknowledgment of a non-existent payment constituted a forgiveness of indebtedness generating discharge of indebtedness income for the joint venture in 1957. Cf. Sec. 752(b) of the Code.

CONCLUSION

With the exception of the Tax Court's decision for Martin Rodman's 1956 tax year, the decisions of the Tax Court should be affirmed. With respect to Martin Rodman's 1956 tax year, the Tax Court's decision should be reversed to reflect the concession of the Commissioner herein. If this Court determines that the joint venture had a bona fide unconditional obligation to Brisson for $900,000 in 1956, then the Tax Court's decisions for 1957 should be reversed.

Respectfully submitted,

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
ERNEST J. BROWN,
DAVID ENGLISH CARMACK,
Attorneys,
Tax Division,
Department of Justice,
Washington, D. C. 20530.

FEBRUARY, 1976.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 20th day of February, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

Philip Shurman, Esquire
55th Floor
20 Exchange Place
New York, New York 10005

Gilbert E. Andrews/cas
GILBERT E. ANDREWS,
Attorney.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

* * *

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

* * *

SEC. 165. LOSSES.

(a) General Rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * *

(c) Limitation on Losses of Individuals.--In the case of an individual, the deduction under subsection (a) shall be limited to--

(1) losses incurred in a trade or business;

* * *

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) Genreral Rule.--In determining his income tax, each partner shall take into account separately his distributive share of the partnership's--

(1) gains and losses from sales or exchanges of capital assets held for not more than 6 months,

(2) gains and losses from sales or exchanges of capital assets held for more than 6 months,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170(c)),

(5) dividends with respect to which there is provided a credit under section 34, an exclusion under section 116, or a deduction under part VIII of subchapter B,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in section 35 or section 242 (but, if the partnership elects to amortize the premiums on bonds as provided in section 171, the amount received on such obligations shall be reduced by the reduction provided under section 171(a)(3)),

(8) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

(b) Character of Items Constituting Distributive Share.--The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

(c) Gross Income of a Partner.--In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) Effective of Partnership Agreement.--A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) Distributive Share Determined by Income or Loss Ratio.--A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if--

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

* * *

(d) Limitation on Allowance of Losses.--A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as

a deduction at the end of the partnership year in which such excess is repaid to the partnership.

SEC. 705. DETERMINATION OF BASIS OF PARTNER'S INTEREST.

(a) General Rule.-The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)--

(1) increased by the sum of his distributive share for the taxable year and prior taxable years of--

(A) taxable income of the partnership as determined under section 703(a),

(B) income of the partnership exempt from tax under this title, and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion; and

(2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of--

(A) losses of the partnership, and

(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

(b) Alternative Rule.--The Secretary or his delegate shall prescribe by regulations the circumstances under which the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis of partnership property upon a termination of the partnership.

SEC. 708. CONTINUATION OF PARTNERSHIP.

* * *

(b) Termination.--

(1) General rule.--For purposes of subsection (a), a partnership shall be considered as terminated only if--

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

(2) Special rules.--

(A) Merger or consolidation.--In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

(B) Division of a partnership.--In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall, for purposes of this section, be considered a continuation of the prior partnership.

SEC. 722. BASIS OF CONTRIBUTING PARTNER'S INTEREST.

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution.

SEC. 731. EXTENT OF RECOGNITION OF GAIN OR LOSS ON DISTRIBUTION.

(a) Partners.--In the case of a distribution by a partnership to a partner--

(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

(2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of--

(A) any money distributed, and

(B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)(2)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

*　　　　*　　　　*

SEC. 741. RECOGNITION AND CHARACTER OF GAIN OR LOSS ON SALE OR EXCHANGE.

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

SEC. 761. TERMS DEFINED.

(a) Partnership.--For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary or his delegate may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of--

(1) for investment purposes only and not for the active conduct of a business, or

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

* * *

(c) Partnership Agreement.--For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

* * *

SEC. 1235. SALE OR EXCHANGE OR PATENTS.

(a) General.--A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are--

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) contingent on the productivity, use, or disposition of the property transferred.

* * *

SEC. 6013. JOINT RETURNS OF INCOME TAX BY HUSBAND AND WIFE.

* * *

(d) Definitions.--For purposes of this section--

* * *

(3) if a joint return is made, the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several.

(e) [as added by Sec. 1, Act of January 12, 1971, P.L. 91-679, 84 Stat. 2063] Spouse Relieved of Liability in Certain Cases.--

(1) In general.--Under regulations prescribed by the Secretary or his delegate, if--

(A) a joint return has been made under this section for a taxable year and on such return there was omitted from gross income an amount properly includable therein which is attributable to one spouse and which is in excess of 25 percent of the amount of gross income stated in the return,

(B) the other spouse establishes that in signing the return he or she did not know of, and had no reason to know of, such omission, and

(C) taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted from gross income and taking into account all other facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such omission,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent that such liability is attributable to such omission from gross income.

(2) Special rules.--For purposes of paragraph (1)--

(A) the determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to community property laws, and

(B) the amount omitted from gross income shall be determined in the manner provided by section 6501(e)(1)(A).

*   *   *

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

*   *   *

(e) Omission From Gross Income.--Except as otherwise provided in subsection (c)--

(1) Income taxes.--In the case of any tax imposed by subtitle A--

(A) General rule.--If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph--

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

*   *   *

SEC. 7482. COURTS OF REVIEW.

(a) Jurisdiction.--The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

*   *   *

SEC. 7701. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof--

*   *   *

(2) Partnership and partner.--The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

*   *   *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.61-13 Distributive share of partnership gross income; income in respect of a decedent; income from an interest in an estate or trust.

(a) In general. A partner's distributive share of partnership gross income (under section 702(c) constitutes gross income to him. Income in respect of a decedent (under section 691) constitutes gross income to the recipient. Income from an interest in an estate or trust constitutes gross income under the detailed rules of part I (section 641 and following), subchapter J, chapter 1 of the Code. In many cases, these sections also determine who is to include in his gross income the income from an estate or trust.

*   *   *

§ 1.702-1 Income and credits of partner.

* * *

(c) Gross income of a partner. (1) Where it is necessary to determine the amount or character of the gross income of a partner, his gross income shall include the partner's distributive share of the gross income of the partnership, that is, the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in section 702(a)(1) through (8)). For example, a partner is required to include his distributive share of partnership gross income:

(i) In computing his gross income for the purpose of determining the necessity of filing a return (section 6012(a));

(ii) In determining the application of the provisions permitting the spreading of income for services rendered over a 36-month period (section 1301, as in effect for taxable years beginning before January 1, 1964);

(iii) In computing the amount of gross income received from sources within possessions of the United States (section 931); and

(iv) In determining a partner's "gross income from farming" (sections 175 and 6073).

(2) In determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a partner's gross income includes his distributive share of partnership gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of partnership gross income from which was derived the partner's distributive share of any item of partnership income, gain, loss, deduction, or credit (as included or disclosed in the partner's return) is considered as an amount of gross income stated in the partner's return for the purposes of section 6501(e). For example, A, who is entitled to one-fourth of the profits of the ABCD partnership, which has $10,000 gross income and $2,000 taxable income, reports only $300 as his distributive share of partnership profits. A should have shown $500 as his distributive share of profits, which amount was derived from $2,500 of partnership gross income. However, since A included only $300 on his return without explaining in the return the difference of $200, he is regarded as having stated in his return only $1,500 ($300/$500 of $2,500) as gross income from the partnership.

* * *

§ 1.704-1 Partner's distributive share.

* * *

(e) Family partnerships--(1) In general--(i) Introduction. The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of subchapter K, chapter 1 of the Code, are to be read in the light of their relationship to section 61, which requires, inter alia, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

* * *

§ 1.705-1 Determination of basis of partner's interest.

* * *

(b) Alternative rule. In certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example (1). The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of $1,500 and has earned and retained an additional $1,500. The total adjusted basis of partnership property is thus $3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or $1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

Example (2). Assume that partner A in example (1) of this paragraph sells his partnership interest to D for \$1,250 at a time when the partnership property with an adjusted basis of \$1,500 had appreciated in value to \$3,000, and when the partnership also had \$750 in cash. The total adjusted basis of all partnership property is \$2,250 and the value of such property is \$3,750. D's basis for his partnership interest is his cost, \$1,250. However, his one-third share of the adjusted basis of partnership property is only \$750. Therefore, for the purposes of the alternative rule, D has an adjustment of \$500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional \$1,500, its property will have an adjusted basis of \$3,750. D's adjusted basis for his interest under the alternative rule is \$1,750, determined by adding \$500, his basis adjustment to \$1,250 (his one-third share of the \$3,750 adjusted basis of partnership property). If the partnership distributes \$250 to each partner in a current distribution, D's adjusted basis for his interest will be \$1,500 (\$1,000, his one-third share of the remaining basis of partnership property, \$3,000, plus his basis adjustment of \$500).

Example (3). Assume that BCD partnership in example (2) of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Assets	Adjusted basis per books	Market value
Cash-------------------------------	\$3,000	\$3,000
Receivables------------------------	4,000	4,000
Depreciable property---------------	5,000	5,000
Land held for investment-----------	18,000	30,000
Total------------------------	30,000	42,000

Liabilities and capital	Per books
Liabilities----------------------------------	$6,000
Capital accounts:	
B--------------------------------------	4,500
C--------------------------------------	4,500
D--------------------------------------	15,000
Total-------------------------------	30,000

The $15,000 representing the amount of D's capital account does not reflect the $500 basis adjustment arising from D's purchase of his interest. See example (2) of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale-----------------	$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally)---	2,000
D's basis adjustment from example (2)------------------------------	500
Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule-----------------	17,500

§ 1.706-1 Taxable years of partner and partnership.

* * *

(c) Closing of partnership year--* * *

* * *

(2) Partner who retires or sells interest in partnership--(i) Disposition of entire interest. A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner's interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. See subparagraph (3) of this paragraph.

(ii) Inclusions in taxable income. In the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner shall include in his taxable income for his taxable year within or with which his membership in the partnership ends, his distributive share of items described in section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership. The application of this subdivision may be illustrated by the following exampe:

Example. Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of $5,000 on that date; that his pro rata share of partnership income up to June 30 is $15,000; and that he sells his interest for $20,000. Under the provisions of section 706(c)(2), the partnership year with respect to him closes at the time of the sale. 'The $15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to $20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest.

The purchaser of this partnership interest shall include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year.

* * *

§ 1.708-1 Continuatuon of partnership.

* * *

(b) Termination--(1) General rule. * * *

* * *

(iv) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties; and, immediately thereafter, the purchaser and the other remaining partners contribute the properties to a new partnership, either for the continuation of the business or for its dissolution and winding up. In the latter case, the new partnership terminates in accordance with subdivision (i) of this subparagraph. See sections 731 and 732 and §§ 1.731-1 and 1.732-1. For election of basis adjustments by the purchaser and other remaining partners, see sections 732(d) and 743(b) and paragraph (d) of § 1.732-1 and paragraph (b) of § 1.743-1.

* * *

§ 1.1235-2 Definition of terms.

For the purposes of sections 1235 and § 1.1235-1--

(a) Patent. The term "patent" means a patent granted under the provisions of title 35 of the United States Code, or any foreign patent granting rights generally similar to those under a United States patent. It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met.

(b) All substantial rights to a patent. (1) The term "all substantial rights to a patent" means all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term "all substantial rights to a patent" does not include a grant of rights to a patent--

(i) Which is limited georgaphically within the country of issuance;

(ii) Which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent;

(iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or

(iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction.

(2) Rights which are not considered substantial for purposes of section 1235 may be retained by the holder. Examples of such rights are:

(i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent:

(ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor's lien), or a reservation in the nature of a condition subsequent (such as a provision for forfeiture on account of nonperformance).

(3) Examples of rights which may or may not be substantial, depending upon the circumstances of the whole transaction in which rights to a patent are transferred, are:

(i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;

(ii) The failure to convey to the transferee the right to use or to sell the patent property.

(4) The retention of a right to terminate the transfer at will is the retention of a substantial right for the purposes of section 1235.

(c) Undivided interest. A person owns an "undivided interest" in all substantial rights to a patent when he owns the same fractional share of each and every substantial right to the patent. It does not include, for example, a right to the income from a patent, or a license limited geographically, or a license which covers some, but not all, of the valuable claims or uses covered by the patent. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of an undivided interest in all substantial rights to a patent.

(d) Holder. (1) The term "holder" means any individual--

(i) Whose efforts created the patent property and who would qualify as the "original and first" inventor, or joint inventor, within the meaning of title 35 of the United States Code, or

(ii) Who has acquired his interest in the patent property in exchange for a consideration paid to the inventor in money or money's worth prior to the actual reduction of the invention to practice (see paragraph (e) of this section), provided that such individual was neither the employer of the inventor nor related to him (see paragraph (f) of this section). The requirement that such individual is neither the employer of the inventor nor related to him must be satisfied at the time when the substantive rights as to the interest to be acquired are determined, and at the time when the consideration in money or money's worth to be paid is definitely fixed. For example, if prior to the actual reduction to practice of an invention an individual who is neither the employer of the inventor nor related to him agrees to pay the inventor a sum of money definitely fixed as to amount in return for an undivided one-half interest in rights to a patent and at a later date, when such individual has become the employer of the inventor, he pays the definitely fixed sum of money pursuant to the earlier agreement, such individual will not be denied the status of a holder because of such employment relationship.

(2) Although a partnership cannot be a holder, each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership. Foe example, if an inventor who is a member of a partnership composed solely of individuals uses partnership property in the development of his invention with the

understanding that the patent when issued will become partnership property, each of the inventor's partners during this period would qualify as a holder. If, in this example, the partnership were not composed solely of individuals, nevertheless, each of the individual partners' distributive shares of income attributable to the transfer of all substantial rights to the patent or an undivided interest therein, would be considered proceeds from the sale or exchange of a capital asset held for more than six months.

(3) An individual may qualify as a holder whether or not he is in the business of making inventions or in the business of buying and selling patents.

(e) Actual reduction to practice. For the purposes of determining whether an individual is a holder under paragraph (d) of this section, the term "actual reduction to practice" has the same meaning as it does under section 102(g) of title 35 of the United States Code. Generally, an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. This may occur either before or after application for a patent but cannot occur later than the earliest time that commercial exploitation of the invention occurs.

(f) Related person. (1) The term "related person" means one whose relationship to another person at the time of the transfer is described in section 267(b), except that the term does not include a brother or sister, whether of the whole or the half blood. Thus, if a holder transfers all his substantial rights to a patent to his brother or sister, or both, such transfer is not to a related person.

(2) If, prior to September 3, 1958, a holder transferred all his substantial rights to a patent to a corporation in which he owned more than 50 percent in value of the outstanding stock, he is considered as having transferred such rights to a related person for the purpose of section 1235. On the other hand, if a holder, prior to September 3, 1958, transferred all his substantial rights to a patent to a corporation in which he owned 50 percent or less in value of the outstanding stock and his brother owned the remaining stock, he is not considered as having transferred such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(3) If, subsequent to September 2, 1958, a holder transfers all his substantial rights to a patent to a corporation in which he owns 25 percent or more in value of the outstanding stock, he is considered as transferring such rights to a related person for the purpose of section 1235. On the other

hand if a holder, subsequent to September 2, 1958, transfers all his substantial rights to a patent to a corporation in which he owns less than 25 percent in value of the outstanding stock and his brother owns the remaining stock, he is not considered as transferring such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(4) If a relationship described in section 267(b) exists independently of family status, the brother-sister exception, described in subparagraphs (1), (2), and (3) of this paragraph, does not apply. Thus, if a holder transfers all his substantial rights to a patent to the fiduciary of a trust of which the holder is the grantor, the holder and the fiduciary are related persons for purposes of section 1235(d). (See section 267(b)(4).) The transfer, therefore, would not qualify under section 1235(a). This result obtains whether or not the fiduciary is the brother or sister of the holder since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

§ 1.6013-5. Spouse relieved of liability in certain cases.

(a) In general. A person shall be relieved from liability for any tax, penalties, additions to tax, interest, or other amounts, to the extent that such liability is attributable to an omission from gross income in a taxable year, and--

(1) He filed a joint return with a spouse in such taxable year,

(2) An amount of income which exceeds 25 percent of the amount of gross income which is stated in the return (as determined in a manner provided by section 6501(e)(1)(A) of the Code) and which is attributable to such person's spouse was omitted from the return, and should have been, under chapter 1 of the Code, included in the return,

*　　　　*　　　　*